

Court File No. CV12-9731-00CL

**ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST**

BETWEEN:

PINNACLE CAPITAL RESOURCES LIMITED in its capacity as general partner of **RED ASH CAPITAL PARTNERS II LIMITED PARTNERSHIP**

Applicant

- and -

**KRAUS INC., KRAUS CANADA INC., STRUDEX FIBRES LIMITED,
and 538686 B.C. LTD.**

Respondents

APPLICATION UNDER SUBSECTION 46(1) and SECTION 243 OF THE *BANKRUPTCY AND INSOLVENCY ACT*, R.S.C. 1985, c. B-3, as amended

**FACTUM OF THE APPLICANT
(APPLICATION FOR INTERIM RECEIVER RETURNABLE MAY 28, 2012)**

May 25, 2012

CASSELS BROCK & BLACKWELL LLP
2100 Scotia Plaza
40 King Street West
Toronto, ON M5H 3C5

John N. Birch LSUC #: 38968U
Tel: 416.860.5225
Fax: 416.640.3057
jbirch@casselsbrock.com

Larry Ellis LSUC #: 49313K
Tel: 416.869.5406
Fax: 416.640.3004
lellis@casselsbrock.com

Lawyers for the Applicant

**ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST**

B E T W E E N:

PINNACLE CAPITAL RESOURCES LIMITED in its capacity as general partner of RED ASH CAPITAL PARTNERS II LIMITED PARTNERSHIP

Applicant

- and -

KRAUS INC., KRAUS CANADA INC., STRUDEX FIBRES LIMITED,
and 538686 B.C. LTD.

Respondents

APPLICATION UNDER SUBSECTION 46(1) and SECTION 243 OF THE *BANKRUPTCY AND INSOLVENCY ACT*, R.S.C. 1985, c. B-3, as amended

FACTUM OF THE APPLICANT

PART I - OVERVIEW

1. This application is for:
 - (a) the consolidation of certain bankruptcy proceedings on the Commercial List for administrative purposes; and
 - (b) the appointment of PricewaterhouseCoopers Inc. ("**PWCI**") as interim receiver over certain companies in the Kraus Group.

2. The Respondents (along with other entities defined below as the "**Kraus Group**") are currently and have, for more than the past two years, been operating pursuant to a series of consecutive forbearance agreements with their major secured lenders.

3. The Kraus Group commenced an extensive sales process in October 2011, in an effort to find a strategic investor willing to assist with turning around its operations and financial performance. Hilco UK Limited (“**Hilco**”) made a bid during this sales process and in February 2012, the Kraus Group advised Hilco that its bid to invest in the Kraus Group was the superior bid.

4. Hilco and the major secured creditors of the Kraus Group negotiated a number of potential investment/purchase structures over a period of approximately ten weeks.

5. Around May 8, 2012, Hilco, through its nominee Red Ash (defined below), took an assignment of all outstanding debt and security of the Kraus Group held by the Senior Lenders, BMOCC, and Nelson, which are the three main secured lenders (all of whom are defined below).

6. Prior to the initial hearing of this application, Red Ash filed bankruptcy applications as against the Respondents other than 538686 B.C. Ltd (the “**Operating Companies**”). In this application, Red Ash seeks the appointment of PWCI as interim receiver under section 46(1) of the *Bankruptcy and Insolvency Act* (“**BIA**”) to monitor the receipts and disbursements of the Operating Companies with a stay in place while the bankruptcy applications are pending.

7. The Kraus Group is currently out of cash and needs immediate financing if it is to survive. Red Ash has developed a business strategy that, if successful, has the potential of saving the Kraus Group from what is otherwise certain liquidation. If court approval of the Purchase Transaction (defined below) is granted, Red Ash is willing to make a

significant investment in the Kraus Group's operations and immediately implement its business strategy.

8. If Red Ash does not obtain Court approval of the Purchase Transaction, it intends to immediately commence an orderly liquidation of the Kraus Group's Canadian operations.

PART II - FACTS

The Parties

9. Pinnacle Capital Resources Limited ("**Pinnacle**") is incorporated pursuant to the *British Virgin Islands Business Companies Act, 2004* and is the general partner of Red Ash Capital Partners II Limited Partnership (collectively, "**Red Ash**"). Hilco, a company incorporated pursuant to the laws of the United Kingdom, is the sole shareholder of Pinnacle.

Affidavit of Christopher Emmott sworn May 25, 2012 ("Emmott Affidavit"), Application Record, Tab 2 at paras. 1, 3 and 4.

10. The operations of the Kraus Group (the collective name for the entities listed below) extend across Canada, the United States, and Australia. However, control of operations is centred in Waterloo, Ontario, where main production occurs and where management of the Kraus Group is centralized. The Kraus Group is made up of the following entities:

- (a) *Strudex Fibres Limited* ("**Strudex**") is a corporation incorporated pursuant to the laws of Ontario and has its registered office in Waterloo. Strudex operates the carpet fibre manufacturing facility located at 65 Northfield Drive, Waterloo, Ontario (the "**Waterloo Premises**"). Strudex is considered the ultimate parent company of all of the Kraus Group operating companies. It sells substantially all of the fibre it produces to Kraus Inc. and to Northstate Inc. Strudex has approximately 100 full time employees, of

which 80 are members of the United Food and Commercial Workers, Local 175 (the “UFCW”);

- (b) *Kraus Inc.* (“**Kraus**”) is a corporation incorporated pursuant to the laws of Ontario and has its registered office in Waterloo. Kraus operates the main carpet manufacturing unit from the Waterloo Premises. Kraus employs approximately 275 people, of which 175 are members of the UFCW. However, these unionized employees are subject to a collective agreement that is separate and distinct from the collective agreement which covers Strudex employees. The majority of Kraus’s sales are to entities within the Kraus Group;
- (c) *Kraus Canada Inc.* (“**Kraus Canada**”) is a corporation incorporated pursuant to the laws of Canada and has its registered office in Winnipeg, Manitoba. Kraus Canada operates the Canadian carpet and flooring distribution network for the Kraus Group. Kraus Canada’s registered office is located in Winnipeg, Manitoba. However, the top-level management of Kraus Canada is conducted from the headquarters of the Kraus Group in Waterloo. More than 50% of Kraus Canada’s purchases are from Kraus. Kraus Canada markets and distributes this product across Canada through its five distribution centres, which are located in British Columbia, Winnipeg, Ontario, Alberta and Nova Scotia. Kraus Canada employs 144 people, including 8 unionized employees who are represented by the Teamsters (as defined below);
- (d) *Anneleen Eckhardt Holdings Ltd.* (“**Anneleen**”) is a corporation incorporated pursuant to the laws of Ontario, and has its registered office in Waterloo. It is a privately-owned holding company which has a direct or indirect majority shareholding interest in each of the other Kraus Group entities. Anneleen does not have direct business involvement with any Kraus Group entity;
- (e) *538626 B.C. Ltd.* (“**Kraus B.C.**”) is a corporation incorporated pursuant to the laws of British Columbia, which has its registered office in Vancouver.

Kraus B.C. is non-operating, has no employees, no material assets, and no material liabilities;

- (f) *Kraus USA Inc.* ("**Kraus U.S.**") is a corporation incorporated pursuant to the laws of Delaware. Kraus USA operates the United States carpet and flooring distribution network for the Kraus Group. Kraus U.S.'s head office is in Clarion, Pennsylvania. Kraus U.S. purchases 40% of its inventory from Kraus with the remaining 60% coming from a variety of third-party flooring manufacturers. Kraus U.S. sells products to flooring retailers, big box stores and renovators. Kraus U.S. employs 100 people, none of whom are unionized. Kraus U.S. maintains distribution centres in Seattle, Washington D.C., and Pennsylvania;
- (g) *Barrett Carpet Mills, Inc.* ("**Barrett**") is a corporation incorporated pursuant to the laws of Georgia. Barrett's offices are located in Dalton, Georgia. Barrett purchases and distributes carpet to flooring and carpet retailers in the US. Barrett also provides other functions for the Kraus Group, including credit, contract manufacturing and research and development. Barrett employs approximately 35 employees, none of which are unionized;
- (h) *Royal Scot Floor Covering Distribution LLC* ("**Royal**") is a corporation incorporated pursuant to the laws of Illinois. Royal is non-operating, has no employees, no material assets and no material liabilities;
- (i) *Kraus Floors LLC* was party to a joint venture that is non-operating, has no employees, no material assets and no material liabilities;
- (j) *Northstate Carpet Mills Pty.* ("**Kraus Australia**") is a corporation located in the Gold Coast region of Queensland, Australia. Kraus Australia is a manufacturer and distributor of carpet and flooring products in Australia. Kraus Australia purchases the majority of its yarn from Strudex and a majority of its carpet from Kraus. Kraus Australia employs approximately 40 employees, of none of whom are unionized.

Emmott Affidavit at para. 14

11. The Kraus Group is a vertically-integrated manufacturer of premium carpet for the commercial and residential market. It is also a distributor in North America of flooring products produced by other manufacturers. It operates two carpet-manufacturing mills:

- (a) the 850,000 square foot flagship mill at the Waterloo Premises, which is owned and operated by Kraus, and
- (b) a smaller mill in Queensland, Australia, which is operated by Kraus Australia.

Emmott Affidavit at paras. 15 and 16

12. The Kraus Group also manufactures fibre for use in carpet manufacturing, and supplies both the Waterloo and Australian mills. The Waterloo mill accounts for approximately 90% of the Kraus Group's manufacturing revenue, while Kraus Australia is responsible for the remaining 10%.

Emmott Affidavit at para. 17

13. Approximately 60% of the Kraus Group's revenues are generated through the sale of carpet. The remaining revenues are generated through the sale of private label and branded laminate, hardwood, cork and other flooring products sourced from third parties. The Kraus Group markets its carpet and flooring products to both the commercial and residential markets.

Emmott Affidavit at paras. 18 and 19

14. As of May 2012, the Kraus Group employed approximately 750 people in Canada, the United States and Australia.

Emmott Affidavit at para. 20

15. The Kraus Group is party to three separate collective agreements (defined below, collectively, the “**Collective Agreements**”) which cover a portion (but not all) of the workforce:

- (a) Strudex and the UFCW are parties to a collective agreement, dated March 20, 2008 (the “**Strudex Collective Agreement**”) and in force until July 2013. Approximately eighty employees are subject to the Strudex Collective Agreement.
- (b) Kraus and the UFCW are parties to a collective agreement, dated July 1, 2009 (the **Kraus Collective Agreement**”) and in force until June 30, 2012. Approximately 175 employees are subject to the Kraus Collective Agreement.
- (c) Kraus Canada and Teamsters Local Union No. 213 (affiliated with the International Brotherhood of Teamsters, of the City of Vancouver, Province of British Columbia) (the “**Teamsters**”) are parties to a collective agreement dated October 1, 2010 (the “**Kraus Canada Collective Agreement**”). The Kraus Canada Collective Agreement expired on September 30, 2011, however, the Kraus Canada Collective Agreement continues to be in force on a year to year basis, subject to rights of renewal, negotiation and termination. Approximately five employees are subject to the Kraus Canada Collective Agreement.

Emmott Affidavit at paras. 21-23.

PENSION PLANS

16. A number of entities in the Kraus Group have employee pension plans, which are summarized in the following chart:

Name of Plan	Covered Employees (No. active and inactive)	Nature of Obligations
Kraus Canada Plan	Kraus Canada (202)	Defined Benefit (until December 31, 2009); Defined Contribution (from January 1, 2010 to present)
Strudex Plan	Kraus and Strudex (150)	Defined Benefit (until December 31, 2009); Defined Contribution (from January 1, 2010 to present)
Executive Plan	Kraus Executives (13)	Defined Benefit
Union Plan	Unionized Employees of Kraus (330)	Defined Benefit (until December 31, 1989)
Canadian Commercial Workers Industry Pension Plan	Unionized employees of Kraus and Strudex ¹	Fixed per hour contributions pursuant to Collective Agreements (January 1, 1990 to present)

Emmott Affidavit at paras. 26-39.

Original Marketing Process

17. In the fall of 2011, Hilco first became aware the Kraus Group's need to identify and source equity capital and Hilco first considered the possibility of acquiring the Kraus Group.

Emmott Affidavit at para. 42.

18. On or about October 20, 2011, Hilco received a letter from PricewaterhouseCoopers Corporate Finance Inc. ("PWCCF"), an affiliate of PWCI, advertising the sale of the assets of a leading manufacturer and distributor of carpet and

¹ To be confirmed.

flooring products with operations across North America and in Oceania (the "**Teaser**"). During this period the Kraus Group retained PWCCF as its financial advisor.

Emmott Affidavit at para. 43.

19. The Teaser stated that additional information would be made available to those parties that executed a confidentiality agreement. The Teaser further advised that non-binding expressions of interest were due to PWCI by December 7, 2011.

Emmott Affidavit at para. 44.

20. In mid-November 2011, representatives of Hilco travelled to Canada, executed a confidentiality agreement and immediately commenced due diligence. Hilco was given access to a data room that was populated with information about the assets and liabilities of the Kraus Group that were for sale.

Emmott Affidavit at para. 45.

21. On or about December 11, 2011, Hilco completed the first stage of its due diligence review of the Kraus Group assets, which included a review of the Kraus Group's corporate structure, its sales and distribution network, its management and employees, its assets and liabilities and a summary of other financial information. On December 13, 2011, Hilco submitted a non-binding expression of interest for consideration by PWCCF (the "**Hilco EOI**").

Emmott Affidavit at para. 46.

22. Hilco learned during the initial phase of the due diligence that the Kraus Group's senior secured creditor was a syndicate of banks (the "**Senior Lenders**").

Emmott Affidavit at para. 47.

23. Hilco is in the business of acquiring financially challenged companies and developing a more efficient business plan with a view to returning them to profitability. The most common method Hilco uses to acquire a business, or its assets, is to purchase the debt and security of the target company's secured creditor. Once the debt and security is acquired, Hilco will use an appropriate insolvency proceeding to acquire the assets into by a Hilco-related corporate structure. In light of this strategy, the Hilco EOI and subsequent bids described below contemplated a purchase of the debt and security of the Senior Lenders.

Emmott Affidavit at para. 48.

24. In or around the middle of December, 2011, PWCCF confirmed to Hilco that the Hilco EOI was one of the superior proposals received and invited Hilco to conduct further due diligence, which included a review of the Waterloo Premises. Around January 24, 2012, Hilco submitted an offer to PWCCF (the "**Hilco Offer**"). The Hilco Offer increased the consideration to the Senior Lenders and required that the Senior Lenders sell a larger percentage interest of their debt and security to Hilco.

Emmott Affidavit at para. 49.

25. From this point in time, the Senior Lenders, together with PWCCF and the Kraus Group, negotiated with Hilco over a period of approximately six weeks and on March 5, 2012, agreed to terms of a letter of intent whereby Hilco agreed to purchase all of the Senior Lenders' first-ranking debt and security position.

Emmott Affidavit at para. 50.

26. As of May 7, 2012, Hilco entered into the three following debt assignment transactions (hereafter collectively referred to as the "**Debt Assignment Transactions**"):

- (a) The Senior Lenders agreed to irrevocably and unconditionally assign their respective interest to Red Ash (the “**Senior Debt Assignment Transaction**”);
- (b) Hilco purchased the debt and security owned by Bank of Montreal in its capacity as assignee of the subordinate secured position of BMO Capital Corporation (“**BMOCC**”) as against the Kraus Group, by way of a master assignment agreement between Red Ash and BMOCC, dated May 8, 2012 (the “**BMOCC Debt Assignment Transaction**”);
- (c) Hilco also purchased the debt and security owned by Nelson Kraus Holdings Limited (“**NKHL**”) as against the Kraus Group, by way of a master assignment agreement between Red Ash and NKHL (the “**Nelson Kraus Debt Assignment Transaction**”).

Emmott Affidavit at paras. 51-53.

Kraus Group’s Debt and Security Structure

The Secured Debt

27. Pursuant to the Debt Assignment Transactions, Red Ash took an absolute, irrevocable and unconditional assignment of each of the loan and security documents referenced in the following sections.

Emmott Affidavit at para. 54.

28. Kraus's primary credit facilities are extended pursuant to a credit and guarantee agreement, dated as of June 28, 2007, pursuant to which Strudex, Kraus, and Kraus Canada are borrowers and guarantors.

Emmott Affidavit at para. 55.

29. This credit agreement was amended on five occasions from August 30, 2007 to March 7, 2011. (The credit agreement, including the amendments and all other relevant modifications, shall hereafter be referred to collectively as the "**Senior Credit Agreement**"). As of April 30, 2012, the total indebtedness outstanding under the Senior Credit Agreement was approximately \$71,115,000.

Emmott Affidavit at paras. 56 and 57.

30. The second ranking secured creditor of the Kraus Group was BMOCC. Kraus as borrower and Strudex as guarantor entered into an amended and restated credit agreement with BMOCC dated as of November 23, 2010 which has subsequently been amended on several occasions (collectively, the "**Junior Credit Agreement**"). The Junior Credit Agreement was a successor to an earlier agreement dated July 24, 2007 whereby BMOCC agreed to lend \$10 million. At the time that the parties entered into the Junior Credit Agreement in 2010, the indebtedness owing to BMOCC exceeded \$15 million because interest on the existing facility had not been paid but was capitalized. BMOCC subsequently assigned all of its rights, entitlements and interest under the Junior Credit Agreement to Bank of Montreal. As of April 30, 2012, the amount outstanding under the Junior Credit Agreement was \$19,714,000.

Emmott Affidavit at para. 58.

31. The third ranking secured creditor of the Kraus Group was NKHL, a corporation controlled by Nelson Kraus (“**Nelson**”), a member of the family that founded the Kraus Group. On November 23, 2010, Strudex executed and delivered to NKHL a promissory note in favour of NKHL (the “**Nelson Promissory Note**”). NKHL subsequently assigned the Nelson Promissory Note to Nelson. As of April 30, 2012, the amount outstanding on the Nelson Promissory Note was \$35,407,000.

Emmott Affidavit at para. 59.

32. Pursuant to the terms of the Nelson Kraus Debt Assignment Transaction, Red Ash purchased the Nelson Promissory Note, from Nelson together with the associated security provided in support thereof.

Emmott Affidavit at para. 60.

The Corresponding Security and Related Defaults

33. The Kraus Group’s debt obligations and liabilities pursuant to the Senior Credit Agreement are fully secured by a series of security agreements over all present and after acquired real and personal property (collectively, “**Senior Security Documents**”)

Emmott Affidavit at para. 61.

34. The Kraus Group’s debts, obligations and liabilities under the Junior Credit Facility are fully secured by a series of security documents (the “**Junior Security Documents**”). The Junior Security Documents establish a general charge against all of the Canadian Assets as well as a specific charge. Generally speaking, the Junior Security Documents rank second in priority, behind the Senior Security Documents.

Emmott Affidavit at paras. 62 and 63.

35. The Kraus Group's debts, obligations and liabilities pursuant to the Nelson Promissory Note are secured by various security documents (collectively the "**Nelson Security**"). The Nelson Security is a general charge against all of the Canadian Assets as well as a general charge against the assets located in the United States. Generally speaking, the Nelson Security ranks third in priority, behind the Senior Security Documents and the Junior Security Documents, respectively.

Emmott Affidavit at paras. 63 and 64.

36. The Kraus Group has been operating pursuant to terms of numerous consecutive forbearance agreements since October 2010. These forbearance agreements note the Kraus Group's numerous defaults pursuant to the Senior Credit Agreement.

Emmott Affidavit at para. 66.

37. The key Kraus Group defaults pursuant to the Senior Credit Agreement include, but are not limited to:

- (a) the Kraus Group was not in compliance with its covenant obligation to maintain the required first lien debt to EBITDA ratio;
- (b) the Kraus Group was not in compliance with its covenant obligation to make certain requisite debt payments in accordance with its debt service coverage ratio;
- (c) the Kraus Group was not in compliance with its covenant obligation to maintain a minimum net worth of the Kraus Group's operations; and

- (d) the Kraus Group's forecast calculations demonstrate that the Kraus Group is not in compliance with its financial performance forecast requirements. (these defaults are collectively referred to herein as the "Defaults").

Emmott Affidavit at para. 67.

38. On May 18, 2012, Red Ash demanded repayment from each Canadian entity within the Kraus Group. Additionally, Red Ash issued its notices of intention to enforce its security, pursuant to section 244 of the BIA.

Emmott Affidavit at para. 68.

Kraus's Declining Financial Performance

39. The Kraus Group's financial performance has declined dramatically over the past several years. Since 2006, its gross revenues have dropped precipitously. In fact, the annual revenue for 2011 is only 60.5% of the 2006 amount. Consolidated annual revenues for the Kraus Group for the years ended December 2006 to December 2011 are as follows:

Year	2006	2007	2008	2009	2010	2011*
Revenue from continuing operations (\$000s)	\$324,639	\$260,510	\$242,309	\$223,076	\$202,767	\$195,089

Emmott Affidavit at para. 71.

40. This dramatic revenue decline has had a significant negative effect on the Kraus Group's EBITDA, which has declined from approximately \$34 million in 2006 to under \$5 million in 2011.

Year	2006	2007	2008	2009	2010	2011*
EBITDA from continuing operations (\$000s)	\$34,751	\$29,068	\$7,222	\$8,900	\$8,305	\$4,814

Emmott Affidavit at para. 72.

41. For each of the last four fiscal years, the Kraus Group has suffered net losses. In 2011, net losses totalled \$14,612,000.

Emmott Affidavit at para. 73.

42. There are several reasons for the financial decline. First, the Kraus Group's performance was badly damaged by the downturn in the U.S. housing market and the subsequent recession in North America, which severely affected the residential and commercial flooring sectors. For example, by 2009 and 2010, North American carpet and flooring sales volumes had declined by 40% from their peak levels in 2005 and 2006, largely as a result of weaknesses in the U.S. housing market and the general effects of the recession. This sales decline was particularly pronounced in the Southeastern and Midwestern United States – historically strong markets for the Kraus Group.

Emmott Affidavit at para. 75.

43. The Canadian carpet market has also experienced a decline over the last several years. Apart from a general decline in the market, the specific circumstances faced by the Kraus Group contributed to the decline in its fortunes. First, as a vertically-integrated

producer and distributor, the Kraus Group faced significant fixed costs, including those associated with maintaining and operating the Waterloo Premises and a North America-wide distribution network. Those fixed costs could not be reduced or downsized to correspond with an overall decline in market demand.

Emmott Affidavit at paras. 76 and 77.

44. Kraus Group was affected by the increase in Canadian dollar over the past several years. A significant portion of its costs are incurred in Canadian dollars but a large proportion of revenues are generated in U.S. dollars. As such, while Canadian dollar expenses remained relatively static or rose, revenues from U.S. sales declined in relative Canadian dollar terms. As such, margins were negatively affected.

Emmott Affidavit at para. 78.

45. At the same time as its revenues were being squeezed by the appreciating Canadian dollar, many expenses rose. For example, the cost of resin, a key component in carpet manufacturing, has increased substantially, thereby further reducing margins.

Emmott Affidavit at para. 79.

46. An additional factor in Kraus's decline has been the impact of the buyout of the Kraus Group's former shareholder, NKHL in 2007 (the "**Share Purchase**"). In 2007, the Kraus Group purchased NKHL's 50% ownership interest in the Kraus Group. The purchase price paid by the Kraus Group consisted of a cash component, together with the Nelson Promissory Note. The Kraus Group financed the cash component of the Share Purchase using its existing cash and through an increased reliance on third party borrowings.

Emmott Affidavit at para. 80.

47. Although the Kraus Group has taken steps to cut costs since 2008, in its manufacturing process and by closing distribution facilities, the Kraus Group still has not been able to improve its financial performance nor to minimize its mounting debt obligations.

Emmott Affidavit at para. 81.

48. Cash flow projections which Red Ash has prepared show that the Kraus Group will require substantial additional funding over the coming weeks. Red Ash is prepared to make additional advances during this period pending the hearing for the application for the appointment of a Receiver.

Emmott Affidavit at para. 82.

Commencement of Bankruptcy Proceedings

49. Red Ash has demanded payment under the Senior Credit Agreement and Junior Credit Agreement and is not prepared to make any further advances other than in the context proposed in these proceedings.

Emmott Affidavit at para. 83.

50. On May 24, 2012, Red Ash commenced an application for a bankruptcy order in respect of Kraus Canada in the Court of Queen's Bench in Winnipeg, Manitoba. Such application is currently returnable before the Registrar in Winnipeg on June 5, 2012. On May 24, 2012, Red Ash also commenced bankruptcy applications on the Commercial List at Toronto in respect of Strudex and Kraus. Such applications have been made returnable before a judge of the Commercial List on June 11, 2012.

Emmott Affidavit at paras. 84 and 85.

51. The bankruptcy applications in respect of Kraus and Strudex are being brought in Toronto, rather than London, pursuant to leave granted by Justice Morawetz on May 17, 2012 following his consultation with the Regional Senior Justice for the Superior Court of Justice, Southwest Region.

Emmott Affidavit at para. 87.

52. Since the Kraus and Strudex bankruptcy applications are being brought in Toronto, Red Ash is also bringing its application for an interim receiver of all three Respondents in Toronto. Although the Kraus Canada bankruptcy application was commenced in Winnipeg, in the event that this court grants an order administratively consolidating the interim receivership application of all respondents in Toronto along with the Kraus and Strudex bankruptcy applications, Red Ash will bring a motion before the Court of Queen's Bench in Winnipeg to transfer the Kraus Canada bankruptcy application to Toronto. Such motion is anticipated to be heard between May 28 and June 8, 2012.

Emmott Affidavit at para. 88.

53. PWCI, a licensed bankruptcy trustee, has agreed to act as interim receiver and as Receiver if so appointed by the court. PWCI is also the bankruptcy trustee which Red Ash wishes to have appointed in respect of the Operating Companies and PWCI has consented to act in this capacity, as well.

Emmott Affidavit at para. 91.

PART III - ISSUES

54. Upon the initial hearing of this application on May 28, 2012, the Applicant seeks the following relief:

- (a) an order pursuant to sections 43(4) and 187(7) of the BIA administratively consolidating the following applications for a bankruptcy order and confirming that the hearing of such applications shall be on the Commercial List at Toronto before a judge:
- (i) bankruptcy application in respect of Kraus brought in the Ontario Superior Court of Justice court file no. 31-OR-207897-T (the “**Kraus Bankruptcy Application**”);
 - (ii) bankruptcy application in respect of Strudex brought in the Ontario Superior Court of Justice as court file no. 31-OR-207896-T (the “**Strudex Bankruptcy Application**”); and
- (b) an order directing that the application for an interim receiver in respect of Kraus Canada, which is the subject of a bankruptcy application in the Manitoba Court of Queen’s Bench (the “**Manitoba Court**”) at Winnipeg, Manitoba as court file no. BK 12-01-02706 and bearing Official Receiver file no. 21-081406 (the “**Kraus Canada Bankruptcy Application**”), be heard in Toronto on the Commercial List;
- (c) an order pursuant to section 46(1) of the BIA appointing PWCI as interim receiver (the “**Interim Receiver**”), in respect of the Operating Companies with the authority to monitor receipts and disbursements but expressly without authority to take possession of any property or operate or manage the businesses of the Operating Companies.

PART IV - LAW AND ARGUMENT

A. The Ontario Bankruptcy Applications Should Be Consolidated and the Kraus Canada Interim Receivership Application is Properly Returnable in Toronto

55. The Court has authority to administratively consolidate the Kraus Bankruptcy Application and the Strudex Bankruptcy Application (collectively, the “**Ontario Bankruptcy Applications**”), pursuant to subsection 43(4) of the *Bankruptcy and Insolvency Act*:

43 (4) If two or more applications are filed against the same debtor or against joint debtors, the court may consolidate the proceedings or any of them on any terms that the court thinks fit.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 43(4)

56. To come within the ambit of the above provision, a party seeking an administrative consolidation must show that the applications it seeks to consolidate have been filed against the same debtor or joint debtors.

57. Kraus and Strudex are joint debtors. Both entities are borrowers and guarantors under the Senior Credit Agreement and Kraus is a borrower and Strudex a guarantor under the Junior Credit Agreement. Further, Kraus and Strudex have both granted security over certain assets pursuant to the Senior Security Documents and the Junior Security Documents.

58. Consolidating the Ontario Bankruptcy Applications will create significant administrative efficiencies and cost savings. These economies stem from avoiding duplication and dealing comprehensively with Kraus and Strudex. Both entities are highly integrated and operate as part of the interdependent Kraus Group. Dealing with Kraus

and Strudex in an unconsolidated manner raises the potential for inconsistent orders by the Court.

59. Administrative consolidation of the Ontario Bankruptcy Applications will not prejudice any of the Kraus Group's creditors. Red Ash, the only secured creditor of Kraus with an economic interest in the Purchase Transaction, fully supports the consolidation. Further, there is no scenario available that will permit any recovery by unsecured creditors. As such, there is no prejudice to unsecured creditors if the Ontario Bankruptcy Applications are administratively consolidated.

60. It is also appropriate that the application for an Interim Receivership over all of the Operating Companies be heard in Toronto, even though the Kraus Canada Bankruptcy Application was commenced in Winnipeg. To the extent that section 43(4) of the BIA does not address consolidation of an application for an interim receiver involving debtors in different localities, section 3 of the *Bankruptcy and Insolvency General Rules* (the "**BIA Rules**") states that the local court rules of a province shall apply to the extent that they are not inconsistent with the BIA or the BIA Rules:

3. In cases not provided for in the Act or these Rules, the courts shall apply, within their respective jurisdictions, their ordinary procedure to the extent that that procedure is not inconsistent with the Act or these Rules.

Bankruptcy and Insolvency General Rules, SOR/98-240, s. 3

61. Under Rule 5.02(2) of the Ontario *Rules of Civil Procedure*, multiple defendants or respondents can be joined in a single proceeding where there are joint claims against them or common questions of law or fact. In fact, under Rule 5.03, all necessary parties must be joined in a single proceeding. These rules state as follows:

Multiple Defendants or Respondents

5.02 (2) Two or more persons may be joined as defendants or respondents where,

(a) there are asserted against them, whether jointly, severally or in the alternative, any claims to relief arising out of the same transaction or occurrence, or series of transactions or occurrences;

(b) a common question of law or fact may arise in the proceeding;

(c) there is doubt as to the person or persons from whom the plaintiff or applicant is entitled to relief;

(d) damage or loss has been caused to the same plaintiff or applicant by more than one person, whether or not there is any factual connection between the several claims apart from the involvement of the plaintiff or applicant, and there is doubt as to the person or persons from whom the plaintiff or applicant is entitled to relief or the respective amounts for which each may be liable; or

(e) it appears that their being joined in the same proceeding may promote the convenient administration of justice. R.R.O. 1990, Reg. 194, r. 5.02 (2).

JOINDER OF NECESSARY PARTIES

General Rule

5.03 (1) Every person whose presence is necessary to enable the court to adjudicate effectively and completely on the issues in a proceeding shall be joined as a party to the proceeding. R.R.O. 1990, Reg. 194, r. 5.03 (1).

62. On this application for an Interim Receiver over Kraus and Strudex, Kraus Canada is a necessary party. Further, the claims asserted against Kraus Canada and the questions of law and fact relating to it are the same as those relating to the other Operating Companies. Joinder of the three Operating Companies in a single proceeding will also promote the convenient administration of justice. As such, the application for an interim receiver of Kraus Canada is properly brought in Toronto in the Superior Court of Justice as part of this proceeding.

B. Transfer of Proceedings to Another Bankruptcy Division

63. The Applicant also relies on section 187(7) of the BIA, which provides as follows:

187(7) The court, on satisfactory proof that the affairs of the bankrupt can be more economically administered within another bankruptcy district or division, or for other sufficient cause, may by

order transfer any proceedings under this Act that are pending before it to another bankruptcy district or division.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 187(7)

64. This provision clearly contemplates that proceedings, once commenced, may be moved to a different jurisdiction even if that is not the locality of the debtor.

65. In this case, the Applicant has brought the interim receivership application in respect of all Operating Companies in Toronto. However, the Kraus Canada Bankruptcy Application was commenced in Winnipeg, Manitoba. The Applicant will subsequently bring a motion before the Manitoba Court to transfer the Kraus Canada Bankruptcy Application to Toronto. The Applicant will rely on section 187(7).

C. PWCI Should Be Appointed Interim Receiver in respect of the Operating Companies

66. The Court has authority to appoint an interim receiver, pursuant to section 46 of the *Bankruptcy and Insolvency Act*:

Appointment of interim receiver

46. (1) The court may, if it is shown to be necessary for the protection of the estate of a debtor, at any time after the filing of an application for a bankruptcy order and before a bankruptcy order is made, appoint a licensed trustee as interim receiver of the property or any part of the property of the debtor and direct the interim receiver to take immediate possession of the property or any part of it on an undertaking being given by the applicant that the court may impose with respect to interference with the debtor's legal rights and with respect to damages in the event of the application being dismissed.

Powers of interim receiver

(2) The interim receiver appointed under subsection (1) may, under the direction of the court, take conservatory measures and summarily dispose of property that is perishable or likely to depreciate rapidly in value and exercise such control over the business of the debtor as the court deems advisable, but the interim receiver shall not unduly interfere with the debtor in the carrying on of his business except as may be necessary for conservatory purposes or to comply with the order of the court.

Place of filing

(3) An application under subsection (1) is to be filed in a court having jurisdiction in the judicial district of the locality of the debtor.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 46

67. An applicant must establish through evidence that
- (a) on a balance of probabilities, the applicant creditor is likely to succeed in obtaining a bankruptcy order, and
 - (b) there is an immediate need for protection of the debtor's estate due to the grave danger that assets will disappear or that the estate is otherwise in jeopardy.

Konopny (Re), [2009] O.J. No. 3548 (Ont. S.C.J.), Applicant's Book of Authorities, Tab 1 at para. 21

68. Red Ash is likely to succeed in obtaining a bankruptcy order. The Operating Companies are insolvent and have committed acts of bankruptcy. They have failed to pay the amount owing to the Applicant in response to the payment demand. The amount of the Applicant's unsecured claim against the Operating Companies is at least \$10,000,000. The Operating Companies are in default in respect of multiple credit facilities.

69. The Kraus Group, including the Operating Companies, has been operating pursuant to numerous consecutive forbearance agreements since October 2010. As outlined in the forbearance agreements, the Kraus Group companies have committed a number of defaults pursuant to the Senior Credit Agreement. Red Ash has demanded payment from the Kraus Group pursuant to the Senior Credit Agreement and Junior Credit Agreement and the Kraus Group is in a precarious financial state.

70. Regarding the second requirement, an applicant shows an immediate need for an interim receiver in order to preserve the value of the debtor's estate where the debtors will

be unable to obtain operational financing absent such a receiver. The court in *Battery Plus Inc. (Re)* held that ensuring financing for the continued operations of the debtor's business is sufficient to show the need to appoint an interim receiver to protect the value of the debtor's estate.

Battery Plus Inc., Re, 2001 CarswellOnt 4122 (Ont. S.C.J.)(C.L.),
Applicant's Book of Authorities, Tab 2 at paras. 8 and 14

71. In that case, all of the debtor's attempts to raise additional capital to fund its continued business operations had failed. The debtor had exhausted its operating facility with the applicant creditor and the debtor would be imminently incapable of paying its employees or its rent.

Battery Plus Inc., Re, 2001 CarswellOnt 4122 (Ont. S.C.J.)(C.L.),
Applicant's Book of Authorities, Tab 2 at paras. 1, 4 and 7

72. Additionally, with regard to the second requirement, Red Ash need not establish that the debtor has engaged in some form of misfeasance or wrongdoing in order to establish the need to protect the debtor's estate through the appointment of an interim receiver.

Royal Bank v. Canadian Print Music Distributors Inc., 2006 CarswellOnt
3780 (Ont. S.C.J.), Applicant's Book of Authorities, Tab 3 at paras. 16 - 19

73. Though the courts decided *Battery Plus Inc., Re* and *Royal Bank v. Canadian Print Music Distributors Inc.* in the context of applications pursuant to section 47 of the BIA and not section 46, the requirements imposed on the court by both sections employ nearly identical language. Namely, section 47(3)(a) stipulates that the appointment of the interim receiver must be "shown to be necessary for the protection of the debtor's estate"

whereas 46(1) uses the language “shown to be necessary for the protection of the estate of the debtor”. Both decisions make clear that they are made in the context of s.47(3)(a).

74. There is an immediate need for an interim receiver to monitor the financial affairs of the Operating Companies and for a stay to be imposed pending the hearing of the Ontario Bankruptcy Applications and the Kraus Canada Bankruptcy Application in order to preserve the value of the Operating Companies’ estates. The Operating Companies are in a precarious financial state and are but a few weeks away from running out of cash.

75. The only feasible source of cash flow funding is Red Ash. However, Red Ash is only prepared to advance any needed funding if an interim receiver is appointed. The appointment of an interim receiver protects the Operating Companies’ assets as well as mitigates any additional risk which Red Ash assumes if it makes further loan advances.


76. The appointment of an Interim Receiver will not prejudice the Operating Companies. Red Ash asks the Court to grant only minimal powers to the Interim Receiver, namely the ability to monitor the Operating Companies’ receipts and disbursements. The proposed order makes it clear that the Interim Receiver is not take possession of any property or operate any part of the business. At all times during the interim receivership, control will remain with management of the Operating Companies.

77. The relief which Red Ash is seeking is consistent with the scope of powers of an interim receiver as set out in BIA subsection 46(2). That subsection makes it clear that the interim receiver cannot interfere unduly with a debtor’s business operations. and that the powers granted to an interim receiver should be those “necessary for conservatory purposes”.

PART V - ORDER REQUESTED

78. The Applicant requests the relief previously set out at paragraph 54.

ALL OF WHICH IS REPECTFULLY SUBMITTED this 25th day of May, 2012.



John Birch

May 25th, 2012

CASSELS BROCK & BLACKWELL LLP
2100 Scotia Plaza
40 King Street West
Toronto, ON M5H 3C2

John N. Birch LSUC #: 38968U
Tel: 416.860.5225
Fax: 416.640.3057
jbirch@casselsbrock.com

Larry Ellis LSUC #: 49313K
Tel: 416.869.5406
Fax: 416.640.3004
lellis@casselsbrock.com

Lawyers for the Applicant

SCHEDULE "A"

1. *Konopny (Re)*, [2009] O.J. No. 3548 (Ont. S.C.J.)
2. *Battery Plus Inc., Re*, 2001 CarswellOnt 4122 (Ont. S.C.J.)(C.L.)
3. *Royal Bank v. Canadian Print Music Distributors Inc.*, 2006 CarswellOnt 3780 (Ont. S.C.J.)

SCHEDULE "B"

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 43(4)

Consolidation of applications

43. (4) If two or more applications are filed against the same debtor or against joint debtors, the court may consolidate the proceedings or any of them on any terms that the court thinks fit.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 46

Appointment of interim receiver

46. (1) The court may, if it is shown to be necessary for the protection of the estate of a debtor, at any time after the filing of an application for a bankruptcy order and before a bankruptcy order is made, appoint a licensed trustee as interim receiver of the property or any part of the property of the debtor and direct the interim receiver to take immediate possession of the property or any part of it on an undertaking being given by the applicant that the court may impose with respect to interference with the debtor's legal rights and with respect to damages in the event of the application being dismissed.

Powers of interim receiver

(2) The interim receiver appointed under subsection (1) may, under the direction of the court, take conservatory measures and summarily dispose of property that is perishable or likely to depreciate rapidly in value and exercise such control over the business of the debtor as the court deems advisable, but the interim receiver shall not unduly interfere with the debtor in the carrying on of his business except as may be necessary for conservatory purposes or to comply with the order of the court.

Place of filing

(3) An application under subsection (1) is to be filed in a court having jurisdiction in the judicial district of the locality of the debtor.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 47(3)

When appointment may be made

(3) An appointment of an interim receiver may be made under subsection (1) only if it is shown to the court to be necessary for the protection of

(a) the debtor's estate; or

(b) the interests of the creditor who sent the notice under subsection 244(1).

Ontario Rules of Civil Procedure, Rules 5.02(2) and 5.03

Multiple Defendants or Respondents

5.02 (2) Two or more persons may be joined as defendants or respondents where,

(a) there are asserted against them, whether jointly, severally or in the alternative, any claims to relief arising out of the same transaction or occurrence, or series of transactions or occurrences;

(b) a common question of law or fact may arise in the proceeding;

(c) there is doubt as to the person or persons from whom the plaintiff or applicant is entitled to relief;

(d) damage or loss has been caused to the same plaintiff or applicant by more than one person, whether or not there is any factual connection between the several claims apart from the involvement of the plaintiff or applicant, and there is doubt as to the person or persons from whom the plaintiff or applicant is entitled to relief or the respective amounts for which each may be liable; or

(e) it appears that their being joined in the same proceeding may promote the convenient administration of justice. R.R.O. 1990, Reg. 194, r. 5.02 (2).

JOINDER OF NECESSARY PARTIES

General Rule

5.03 (1) Every person whose presence is necessary to enable the court to adjudicate effectively and completely on the issues in a proceeding shall be joined as a party to the proceeding. R.R.O. 1990, Reg. 194, r. 5.03 (1).

PINNACLE CAPITAL RESOURCES LIMITED
in its capacity as general partner of RED ASH
CAPITAL PARTNERS II LIMITED
PARTNERSHIP

Applicant

and KRAUS INC., KRAUS CANADA INC., STRUDEX FIBRES LIMITED and
538626 B.C. LTD
Respondents

Court File No. CV12-9731-00CL

**ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)**

PROCEEDING COMMENCED AT
TORONTO

**FACTUM OF THE APPLICANT
(APPLICATION FOR INTERIM RECEIVER
RETURNABLE MAY 28, 2012)**

Cassels Brock & Blackwell LLP
2100 Scotia Plaza
40 King Street West
Toronto, ON M5H 3C2

John N. Birch LSUC #: 38968U
Tel: 416.860.5225
Fax: 416.640.3057
jbirch@casselsbrock.com

Larry Ellis LSUC #: 49313K
Tel: 416.869.5406
Fax: 416.640.3004
lellis@casselsbrock.com

Lawyers for the Applicant